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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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Person To Contact: _____, ID No. _____

Telephone Number:

Refer Reply To:
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August 04, 2011

Legend:

Taxpayer =

Partnership =

State B =

Type A property =

Court =

Bank A =

Bank B =

a =**b** =C =d =

Date 1 =

Date 2 =

Month 1 =

Year 1 =

Year 2 =

Year 3 =

Dear :

This is in reply to a letter dated April 7, 2011, requesting a ruling on behalf of Taxpayer. Taxpayer requests a ruling that its allocable share of payments received by Partnership resulting from the settlement of a lawsuit described below are not includible in Taxpayer's gross income solely for purposes of the gross income tests described in §§ 856(c)(2) and (3) of the Internal Revenue Code.

Facts:

Taxpayer is a State A corporation that has elected to be taxed as a real estate investment trust ("REIT") under § 856. Taxpayer owns all of its assets and conducts substantially all of its operations through Partnership, a State B limited partnership. Taxpayer owns approximately a% of the equity interests of Partnership.

Taxpayer and its affiliates own approximately one hundred Type A properties. Most of the Type A properties are leased by Partnership to taxable REIT subsidiaries that have hired Type A property management companies to manage the properties. Partnership also owns mortgages secured by Type A properties and mezzanine loans secured by interests in limited liability companies and partnerships that own Type A properties.

In Month 1, Partnership, through a disregarded entity, purchased a participation interest in a mezzanine loan for \$b from Bank A ("the Loan"). Taxpayer represents that the Loan constituted a qualifying real estate asset. On or about Date 1, Partnership filed a complaint commencing an action in Court asserting certain claims against Bank A relating to Partnership's purchase of the Loan. Partnership asserted that, at the time the Loan was acquired, Bank A either knew or should have known that the Loan was either in default or that events which could lead to a default existed. The claim asserted a breach of contract because Bank A had represented that the Loan was not in default.

The issuer of the Loan filed for Chapter 11 bankruptcy protection in Year 1. Partnership determined that the Loan was worthless in Year 2. On or about Date 2, Partnership entered into a Settlement Agreement and Release with Bank B, as

successor by merger to Bank A, pursuant to which Bank B agreed to pay up to \$c to dismiss with prejudice all claims asserted by Partnership. The parties reached a mutual release of claims and agreed the settlement did not constitute an admission of liability. Partnership expects to receive approximately \$d (the "Settlement Proceeds") pursuant to the agreement after a contingency fee is paid to its counsel. Partnership will include the Settlement Proceeds in its taxable income in Year 3. Taxpayer represents that its allocable share of the Settlement Proceeds, if treated as nonqualifying income for purposes of the 95% income test of § 856(c)(2), would cause Taxpayer to fail to satisfy the 95% income test.

Law and Analysis:

Section 856(c)(2) provides that in order for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer), abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees, and gain from certain sales or other dispositions of real estate assets.

Section 856(c)(3) provides that in order for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (other than property in which the corporation is a dealer), dividends from REIT stock and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of Part II of subchapter M of the Code, the Secretary is authorized to determine, solely for purposes of such part, whether any item of income or gain which – (i) does not otherwise qualify under § 856(c)(2) or (3) may be considered as not constituting gross income for purposes of § 856(c)(2) or (3), or (ii) otherwise constitutes gross income not qualifying under § 856(c)(2) or (3) may be considered as gross income which qualifies under § 856(c)(2) or (3).

Under section 1.856-3(g) of the Income Tax Regulations, a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and to be entitled to the income of the partnership attributable to that share. For purposes of § 856 the interest of a partner in the partnership's assets is determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the

partnership retain the same character in the hands of the partners for all purposes of § 856.

Section 61(a) provides that, except as otherwise provided, gross income includes all income from whatever source derived.

The legislative history underlying the tax treatment of REITs indicates that the central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-823 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

The Settlement Proceeds, resulting from a dispute concerning Taxpayer's participation in a mezzanine loan, constitute gross income that does not qualify under §§ 856(c)(2) or (c)(3). Pursuant to § 856(c)(5)(J), that income may either be considered as not constituting gross income under §§ 856(c)(2) or (c)(3) or as qualifying gross income under those provisions. Under the facts of the instant case exclusion of the Settlement Proceeds from gross income for purposes of §§ 856(c)(2) and (c)(3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions. Accordingly, we rule that the Settlement Proceeds do not constitute gross income for purposes of §§ 856(c)(2) and (3), as provided in § 856(c)(5)(J)(i).

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code.

This ruling is directed only to the taxpayer requesting it. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Thomas M. Preston
Thomas M. Preston
Senior Counsel, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)